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Why Indiana Repealed the Inventory Tax

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At the turn of the 21st century, only a handful of states imposed an inventory tax, which was and is seen as a "stumbling block" for creating and maintaining worker's jobs.

The phase-out and repeal of the inventory tax in Indiana was to be phased out over 5 years and was implemented as a Constitutional Amendment.

The Joint Resolution was passed by two separately elected General Assemblies and was approved by a majority (71%) of voters during the 2004 General Election.

The announcements at Honda, Cummins and Toyota were facilitated in-part by Indiana's friendlier tax climate.

The Inventory Tax

During the second half of the last century, property taxes on business inventories became less and less popular. More and more, so-called inventory taxes were viewed as counterproductive to maintaining and creating jobs in manufacturing, warehousing and transportation of U.S. products.

In 1966, 44 states assessed property taxes on business inventory. By 2002, that number had dwindled to just 18 and many of those allowed local units of government to provide exemptions. Here in Indiana, rumblings for a repeal were gaining steam. Many, including commercial realtors, saw Indiana's tax on inventory as "a stumbling block" for business investment in the state and some local government leaders agreed.

In the 2002 Special Session of the Indiana General Assembly, legislators began a phase-out of the state's inventory tax which was to be completed by March 1, 2006 for taxes payable in 2007. In addition, lawmakers gave counties the option of eliminating the inventory tax early to spur economic growth in their given area. Several counties took advantage of this option. An Associated Press dispatch from January of 2003 reported many counties welcomed this new-found opportunity to boost their attractiveness to business. Wabash County Councilman Paul Sites said "If you can help out local businesses, farmers, etc., and do away with the inventory tax, why not?" Wells County Assessor Connie Prible said the county took in about $1.4 million from the inventory tax in 2002, but she still pushed to eliminate it. "To do economic development, we had to," she said at the time.

4%

The estimated impact of inventory tax elimination on statewide property tax bills.

Source: Larry DeBoer, Purdue University.

House Enrolled Act 1001, passed during the Special Session of 2002, included a provision for businesses to take an additional valuation adjustment of 35 percent on top of existing valuation adjustments for reportable inventory values beginning in 2003. The new law also expanded an existing tax exemption traditionally applied to finished goods waiting to be shipped out of state to include raw materials and work-in-progress, another move to bolster Indiana's job market.

The impact of these two items reduced inventory taxes for all businesses and virtually eliminated the tax for most Indiana manufacturers. Indiana voters ratified the complete repeal of the state's inventory tax during the general election of 2004 when nearly 71 percent of voters — 1,392,517 Hoosiers —supported the elimination of the inventory tax.

Indiana's central location positions our state as a natural warehousing and logistical hub for interstate commerce. Hoosiers are within two days' drive of 65 percent of America's population--more than 196 million people. In order to best use our postition, the *Crossroads of America*, it was necessary to rid current and prospective Hoosier businesses of burdensome inventory taxes.

Unpopular among businesses, inventory taxes are often a deciding factor in site selection for many industries. In Indiana, this problem was exacerbated by Hoosiers' reliance on businesses to shoulder a disproportionate amount of the property tax bill. Dr. Larry DeBoer, a professor of Agricultural Economics at Purdue University, and William Sheldrake, former head of the Fiscal Policy Institute, both testified at a 2007 meeting of the State Tax and Financing Policy Committee that Indiana residential property had been consistently assessed lower relative to business and commercial property, creating a greater and unfair reliance on business inventory taxes to reinforce property tax revenue.

Economists agree business investment may thrive where taxes are lower. In his 2002 article "Taxing Inventory: An Analysis of its Effects in Indiana," Dr. DeBoer analyzed the relationship between inventory tax rates and inventory location with the hypothesis that more inventory would be located in low-tax areas. His analysis showed each 10 percent reduction in inventory taxes raised the assessed value of inventories by about 4 percent. He theorized that reduction or elimination of property taxes on inventories would likely increase the quantity of inventories held in Indiana. Eliminating the inventory tax aligned Indiana with Illinois, Michigan and 29 other states that choose not to subject businesses to an inventory tax of any kind and led to a boom in investment and economic development.

Before the phase out of the inventory tax began, numerous companies were deciding whether or not they could afford to maintain their operations in Indiana. With the weight of an unwelcome and unwieldy tax removed, Indiana is once again at the forefront of the logistics industry. Since 2005, Indiana has garnered over 45,000 new job committments; 64% of those new jobs are in manufacturing, transportation, distribution or logistics indus-

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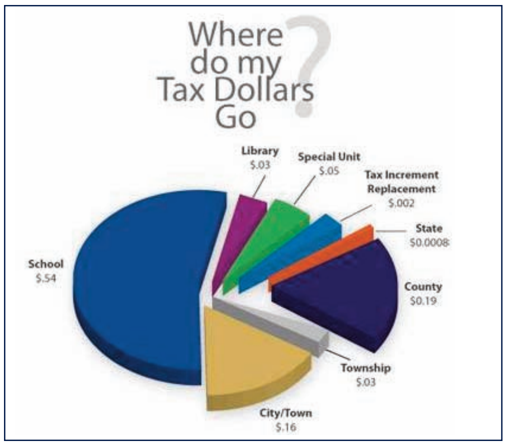
tries. In the first five months of 2007, there have been several announcements bringing hundreds of jobs and millions of dollars in investment. These announcements include an expansion of L&D Mail Masters, a direct mail and logistics company in New Albany; an expansion at Tomasco Indiana LLC, a Honda parts manufacturer in Winchester; a manufacturing and distribution facility expansion at Zimmer Holdings, Inc. in Warsaw; and distribution center expansions for Bensussen Deutsch & Associates, Inc. (the nation's premier Merchandise Agency[SM]) in Plainfield and Hatchette Book Group USA (the 3rd largest publisher in the world) in Lebanon.

Indiana's inventory tax phase-out also put more control into the hands of local governments who are the beneficiaries of 99.9 percent of property tax revenue. The General Assembly provided an option for individual counties to phase out the tax before the deadline by passing a county ordinance, thereby creating a tax environment more favorable to economic development and investment. This move could be funded three different ways: 1) The county could do nothing and allow the property tax burden to shift from businesses to all property owners, 2) The county could choose to increase the local County Economic Development Income Tax to an amount necessary to offset the loss of property tax revenue previously received through taxes on inventory, or 3) Local governments could choose to tighten their budgets and live within their means. Unfortunately for taxpayers, options 2 and 3 were largely ignored.



County Economic Development Income Tax

In a July 12, 2007, news release, Indianapolis Mayor Bart Peterson complained, "The elimination of the inventory tax has shifted the tax burden from businesses to homeowners this year without any State support to replace it." While Peterson's statement may be viewed as technically correct, it fails to acknowledge the intent and outcome of the 2002 legislation. Replacing phased-out inventory taxes with direct state funding was not the purpose of the 2002 law. Instead, the General Assembly gave tools to units of local government to impact the phase-out in ways that would most benefit their citizens and locales. Peterson's Marion County was among those choosing not to make full use of such tools.

A provision in House Enrolled Act 1001 passed during the Special Session of 2002 provided that counties could adopt a 100 percent inventory deduction prior to 2006-2007 and then, by ordinance of the County Income Tax Council or County Council, could increase the EDIT tax and use the proceeds to adopt a higher homestead credit helping however. There were restrictions on the rate, depending on the county, but all counties had the option to raise an EDIT. Even local governments who had already reached the cap on combined county income taxes were provided an opportunity to raise the EDIT by an additional 0.25 percent to provide property tax relief.

Not to be overlooked is that after the initial 35 percent reduction in reportable inventory values, the inventory tax was to be phased out. Counties had 5 years to make an adjustment in their property tax structure by either raising an EDIT or reducing their levies. Some took advantage, but many local governments simply failed to act.

The new EDIT rates could have been imposed as early as January 1, 2003. According to LSA's "Indiana Handbook of Taxes Revenues and Appropriations," Fiscal Year 2004 shows seventeen counties increased their EDIT rate. The lowest increase was 0.07% and the highest was 0.5%. Nineteen counties increased their EDIT rate in FY 2005, 7 increased in FY 2006, and 8 increased in FY 2007.

Some counties increased the EDIT more than once, but by FY 2007, 46 counties had raised the EDIT above FY 2003 levels. However, only 43 counties used an EDIT increase to fund additional Homestead Credits and provide meaningful property tax relief. Forty-nine counties allowed the tax on inventory to linger on until the statutory deadline and either tightened their fiscal belts or allowed a complete shift in property tax valuation from businesses to property owners. Interestingly, but perhaps not coincidentally, all of the counties for which the state was forced to order reassessments in 2007 failed to take proactive steps to mitigate the loss of revenue caused by the repeal of the inventory tax.

Conclusion

With recent increases in property tax assessments it has been asked whether Indiana acted wisely in eliminating the inventory tax. Some communities may be facing apparent "crises," but reinstating the inventory tax could risk sending our state and local economies into a tailspin and could lead to major losses in business investment.

Citizens across the United States are struggling with property taxes in Indiana. These taxes are a function of local government spending and a permanent remedy ultimately rests on the ability of local governments to value each and every taxpayer dollar they receive. Many local leaders have not taken the opportunities provided by the General Assembly to decrease their dependence on an antiquated property tax system.

Addressing and solving this problem will pay long-term economic dividends well into the future, and the Senate should embrace the many positive steps it has taken--including the repeal of the inventory tax.

Acknowledgments: Dr. Larry DeBoer (Purdue University), the Association of Indiana Counties, the Indiana Fiscal Policy Institute, the Legislative Services Agency, Dan Novreske & Vivienne Ross,the National Conference of State Legislatures, and the Associated Press.

Indiana state government receives less than 0.1% of property tax revenue.

Because over 99.9% of property tax revenue goes to local governments, the General Assembly gave local officials new tools, in the form of LOITS, to decrease their current and future reliance on property taxes.

Under HEA 1478, homeowners' property tax bills can be cut on average by 60 percent in a county that adopts a 1.0 percent local option income tax.